BEFORE THE

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

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INTERSTATE POWER COMPANY		
 Re: Delivery Services Tariffs submitted pursuant to Section 16-104 and Section 16-108 of the Illinois Public Utilities Act	Docket No. 01-0628	

REBUTTAL TESTIMONY OF

Enrique Bacalao

FOR

Interstate Power Company

TP 3. 20 December 12, 2001

1	Q.	Please state your name and business address.
2	A.	My name is Enrique Bacalao and my business address is 222 West Washington
3		Avenue, Madison, Wisconsin 53703.
4	Q.	Please describe your educational background and current position.
5	A.	I have a Bachelor of Arts degree in economics and a Master of Business
6		Administration degree from Columbia University in New York. I am presently
7		Assistant Treasurer and Director of Finance of Alliant Energy Corporation (AEC).
8	>~	I also serve as Assistant Treasurer of Wisconsin Power and Light Company
9		(WPL) and of Interstate Power Company (IPC). Prior to my employment by
10		Alliant Energy, I held the position of Vice President, Corporate Banking, in the
11		Chicago Branch of The Industrial Bank of Japan, Limited for three years. Prior to
12		that I served eight years in the London dealing room of the same banking
13		institution, where I headed the corporate desk for three years after establishing the
14		commercial paper dealing function for the bank.
15	Q.	Did you previously provide direct testimony regarding Interstate Power
16		Company's (IPC)'s cost of equity capital and what would constitute a fair
17		return on common equity for Interstate Power Company (IPC)?
18	A.	Yes I did.
19	Q.	What is the purpose of your rebuttal testimony?
20	A.	The purpose of my rebuttal testimony is to respond to the direct testimony
21		prepared by ICC Staff Witness Sheena Kight in this docket.
22	Q.	Please summarize your comments on Ms. Kight's estimate of the IPC cost of
23		equity.

24 A. Ms. Kight's calculations do not correctly reflect the cost of common equity for IPC. The two samples she used to calculate equity returns - integrated electric 25 utility companies and gas distribution companies - are not appropriate samples for 26 27 the return on equity calculations. 28 Please discuss why the samples selected by Ms. Kight are not appropriate for Q. 29 determining the cost of equity of IPC. 30 A. Risk-averse equity investors will want to invest in companies where the expected 31 equity returns are commensurate with the risks of owning those investments. In a 32 perfect market, expected returns should be the same for equity investments of a given level of risk. To achieve this equilibrium in the return vs. risk relationship, 33 investors will look across various industries when making their investment 34 decisions. They will not just focus on equity investments in one industry; to do so 35 36 would cause them to miss favorable investment opportunities. Ms. Kight's use of a sample of integrated electric utility companies and a sample of gas distribution 37 38 companies incorrectly implies that investors only have the choice of investing in one particular industry. In order to correctly determine the expected return on 39 equity for IPC, a sample should be created with companies from various 40 industries, as long as those companies have a level of risk similar to that of IPC. 41 42 Please discuss why the sample of gas distribution companies selected by Ms. Q. Kight is not appropriate for determining the cost of equity of IPC. 43 44 This proceeding involves electric delivery services. Gas services are not a part of A.

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this proceeding, so using a selection of gas distribution companies, in isolation,

46		for a sample of comparables is inappropriate. Ms. Kight did not provide a reason
47		for selecting the gas distribution companies for her sample.
48	Q.	Please comment on the alleged "flaws" mentioned by Ms. Kight in her
49		testimony regarding your cost of equity calculations.
50	A.	Ms. Kight made the following comments regarding my cost of equity calculations.
51		I will address each of these in sequence.
52		1) "Mr. Bacalao's sample in not representative of the risk inherent in
53		IPC's electric delivery service operations."
54		Safety Rank as a Measure of Risk - Ms. Kight argues that the Value Line Safety
55		Rank is an imprecise measure of risk and that to use such measure to screen for
56		sample companies is inappropriate. She also speculates that stocks with different
57		assigned safety numbers may be more similar in risk than stocks ranked far apart
58		with identical assigned safety numbers.
59		Response: Ms. Kight's comment about the Safety Rank being an
60		imprecise measure of risk is clearly incorrect. Page 13 of The Value Line
61		Subscriber's Guide (EB3.2) describes the Safety Rank as "a measure of risk
62		avoidance" and mentions that "The Safety Rank changes infrequently and, until it
63		does, may be taken as a forecast of relative risk avoidance". Page 17 of The
64		Value Line Subscriber's Guide (EB3.2) shows that the percentage declines in
65		market value gets successively larger as risk is increased (based on Safety Rank
66		Group 1, 2, 3, 4 and 5). The infrequency of the change in Safety Rank and the
67		historical performance data shown on page 17 both indicate that the Safety Rank

is a precise measure of risk and would be an appropriate measure to use in screening sample companies.

In addition, Ms. Kight's comment that stocks with different assigned safety numbers may be more similar in risk than stocks ranked far apart with identical assigned safety numbers is seemingly based solely on her speculation. Ms. Kight has not provided any evidence to support that this is indeed the case.

Lack of Safety Rank at IPC – Ms. Kight's comments on the lack of a Safety Rank for IPC imply that my use of the Alliant Energy Corporation Safety Rank as a proxy for the Safety Rank of IPC is not appropriate for selecting a sample of comparable companies. She indicates that the use of the AEC Safety Rank, if it is affected by the risks of the unregulated activities of Alliant Energy Resources, could not be used to measure the equity risk of IPC's electric delivery service operations on a stand-alone basis because it would reflect the risk of the unregulated affiliate.

Response: I do not agree with Ms. Kight's comments regarding the use of the AEC Safety Rank for the IPC analysis. There is sufficient evidence to show that the AEC Safety Rank is a good proxy for the equity risk of IPC. First, the Value Line Safety Rank of AEC has clearly not changed due to the non-regulated activities of AER. The Oct. 6, 2000 Value Line Report for AEC (EB____3.3) confirms that the Safety Rank has remained at "2" since the 1998 merger. Second, prior to the recent rating changes on Oct. 17, 2001, the Standard & Poor's long-term corporate credit ratings for AEC and IPC were both equivalent at "A+". These measures both support a similar level of risk at AEC and IPC and support

91 the usefulness of the AEC Safety Rank as a proxy for measuring the equity risk of 92 IPC in selecting a number of comparable companies. 93 2) "Mr. Bacalao's comparable earnings methodology does not provide 94 valid estimates of the investor-required rate of return on IPC's 95 common equity." 96 Ms. Kight asserts that the comparable earnings methodology is flawed because it 97 incorrectly implies that the earned book returns are equivalent to the required 98 market returns. 99 There is a legal basis for looking at the comparable book 100 equity returns. As set forth by the United States Supreme Court decisions in the 101 102 103 104 105 106

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companies of similar risk.

Hope, Bluefield and Permian Basin cases, a public utility company should be permitted an opportunity to earn a return on common equity that is sufficient to: (1) enable it to attract, on reasonable terms, the capital necessary to support its business operations and fulfill its duty to serve the public; (2) maintain and support a sound credit rating; and (3) provide a return on equity to investors that is comparable to the returns on other investments considering their relative investment risks. In order to determine if the returns indicated in (3) are achieved, it is necessary to consider the historical book equity returns of my sample

Despite differences that may occur in equity book vs. equity market values at a particular point in time, this calculation is also useful as a reasonableness test of the investor-required equity returns. Given that the data in this calculation cover a ten-year period of time, and given that the equity market values have had 114 a significant amount of variation over that time, there would be times when book/equity ratios are higher and lower than 1.0. Over the long-run, this 115 116 calculation should be used in conjunction with my other models as a check on the reasonableness of the other calculations. 117 118 3) "Mr. Bacalao's DCF analysis contains an unreasonable terminal growth rate." 119 Ms. Kight indicates that my use of the long-term inflation rate of 3.1% as a 120 121 terminal growth rate in my DCF calculation is unreasonable. In addition, this 122

implies that IPC will not experience real growth.

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Response: I agree with Ms. Kight that my use of the long-term inflation rate of 3.1% as a terminal growth rate would result in no real growth and that it is implausible that IPC would actually experience a real growth rate of zero over such a long period of time. I used this 3.1% estimate for two reasons. First, this number is conservative as it represents a worst case scenario in which zero real growth is expected. Second, long-term growth estimates past five years are difficult to justify and can be unreliable. I recognize that a terminal growth rate in excess of the long-term inflation rate of 3.1% would be appropriate. Using a higher and more appropriate terminal growth rate in my DCF model would result in a higher cost of equity for IPC compared to what I show in my calculations.

4) "Mr. Bacalao's risk premium model is based on the incorrect assumption that historical risk premiums are reasonable estimates of current investor-required risk premiums."

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Ms. Kight argues that the historical premiums are not reliable proxies of current or future risk premiums and as such, do not adequately measure investors' current return requirements.

Response: I agree that investor-required risk premiums should be forward looking. However, this does not necessarily imply that long-run historical risk premium data is not valid or that the results of my risk premium calculation are invalid. Comparing the historical risk premium data over a long period of time is useful as a reasonableness test of the estimated forward looking risk premium. My calculation should be used in conjunction with my other models as a check on the reasonableness of the other calculations.

5) "Mr. Bacalao's CAPM analysis is seriously flawed and does not accurately reflect the cost of equity for his sample."

Ms. Kight states that my re-levering of sample company betas to reflect the leverage of IPC results in higher implied risk for my sample. She also claims that because of my adjustments, many of the companies in my sample would no longer receive the same Safety Rank if such changes were made.

Response: Ms. Kight's claim of a resulting Safety Rank change is seemingly based solely on her speculation. She has not provided any evidence that this is the case. In addition, she states that the Safety Rank is a function of both operating risk and financial leverage. Page 13 of The Value Line Subscriber's Guide (EB____3.2) indicates that the Safety Rank is based mainly on a "company's relative financial strength and the stock price's stability". The stock price stability is an additional factor not mentioned by Ms. Kight. The

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159		impact of the stock price stability on the Safety Rank adds additional complexity
160		to the Safety Rank determination. In summary, my leverage adjustments would
161		only impact one factor in the Safety Rank determination, so it is not a forgone
162		conclusion that a change is the company leverage would necessarily result in a
163		change in the Safety Rank.
164	Q.	Does this conclude your rebuttal testimony?
165	A.	Yes, it does.